ANNUAL REPORT
OF THE
PENSION MANAGEMENT OVERSIGHT COMMISSION

Indiana Legislative Services Agency
200 W. Washington Street, Suite 301
Indianapolis, Indiana 46204

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INDIANA LEGISLATIVE COUNCIL
2000

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I. STATUTORY AND LEGISLATIVE COUNCIL DIRECTIVES

The Pension Management Oversight Commission (PMOC) was created under IC 2-5-12 to oversee and study public retirement funds in Indiana and to study other topics as assigned by the Legislative Council. The Commission consists of twelve members; four Senators, four Representatives, and four lay members. The chairman of the Legislative Council appoints the chair of the Commission.

Under IC 2-5-12 the Commission is required to do the following:

1. Study the investment and management practices of the boards of the public retirement funds.

2. Determine what constitutes adequate wage replacement levels at retirement (including benefits from public retirement funds and social security) for public employees.

3. Study the impact of federal law and proposals concerning pensions, annuities, and retirement benefits.

4. Study the public safety officers' retirement funds established under IC 36-8.

5. Study methods and levels of funding for public retirement plans.

In addition, the Legislative Council assigned the following additional responsibilities to the Commission during the 2000 interim:

1. Study local public safety personnel pensions.

2. Study state funded health care, including prescription drug insurance for retired state employees.

3. Study issues dealing with chief of police and town marshal pensions and health insurance.

4. Study the benefit of permitting members of the Public Employees' Retirement Fund to make any discretionary contributions to their annuity savings accounts in annuities provided by additional licensed insurers.

II. INTRODUCTION AND REASONS FOR STUDY

Since its inception in 1985, the Commission has provided a bipartisan forum for the oversight of Indiana's public pension funds and for the study of proposed changes in the laws governing Indiana's public pension funds. This year, as it does each interim, the Commission reviewed administrative issues raised by PERF and TRF. The Commission also reviewed proposed changes concerning the Judges Retirement Fund and the Prosecuting Attorneys Retirement Fund, and it heard testimony on a number of other topics related to public employee pensions and benefits.

As part of its general oversight of Indiana's public pension funds, the Commission decided to hear testimony concerning PERF and TRF funding levels in order to ensure that the pensions earned by public employees are adequately funded.

The Commission also heard testimony on the results of PERF and TRF investments in equities. This was done to monitor the funds' activities and to determine the fiscal consequences of the 1996 amendment to the Indiana Constitution allowing public pension funds to invest in equities.

Because of the heavy burden faced by municipalities in paying for police and firefighter pensions, the Commission decided to hear testimony concerning: (1) distributions from the Pension Relief Fund; and (2) additional pension relief options.

Recent changes in federal law have effectively negated the existing Indiana laws imposing a limit on how much a retired PERF or TRF member may earn when reemployed in a PERF-covered or TRF-covered position. The Commission heard testimony on this issue to determine options the General Assembly could pursue in response to the changed federal law.

The Commission determined that it would explore ways in which the PERF and TRF benefit structure could be changed in order to benefit long-term, lower-paid employees. The Commission therefore heard testimony concerning the existing benefit structure and also reviewed various proposals concerning minimum benefits for PERF and TRF members.

The Legislative Council also directed the Commission to study four specific topics.

III. SUMMARY OF WORK PROGRAM

The Commission met four times during the interim following the conclusion of the 2000 Session of the General Assembly. All four meetings were held at the State House in Indianapolis.

<u>The first meeting, held on August 8, 2000,</u> was devoted to an introduction of the issues that the Commission planned to study during the interim. The Commission heard testimony concerning: (1) PERF and TRF funding levels; (2) an overview of the Pension Relief Fund and alternatives

concerning additional pension relief for municipalities; (3) the effects of recent federal legislation on the earnings limitations for retired PERF or TRF members reemployed in PERF-covered or TRF-covered positions; and (4) various other PERF and TRF administrative issues.

At its second meeting, held on September 14, 2000, the Commission heard testimony concerning: (1) the impact of PERF and TRF investment in equities; (2) projections of distributions that will be paid from the Pension Relief Fund; (3) additional alternatives concerning pension relief for municipalities; (4) the impact of pension obligations on municipal finances; (5) pensions for retiring police officers and firefighters under the 1977 Fund; (6) prescription drug coverage for retired state employees; (7) health insurance for retired state employees; (8) proposals concerning the Judges' Retirement Fund; (9) proposals concerning the Prosecuting Attorneys Retirement Fund; (10) a comparison between Indiana pension benefits and those in other states; (11) a proposal to provide some form of minimum benefit for PERF and TRF members; and (12) possible approaches that the General Assembly could take in addressing the PERF and TRF earnings limitation issue.

At its third meeting, held on October 4, 2000, the Commission heard testimony concerning: (1) establishing 401(a) qualified plans for converting unused accrued leave of state employees; (2) an update on the Indiana Deferred Compensation Plan; (3) the fiscal impact of basing police and firefighter pensions under the 1977 Fund on actual salaries, rather than on salaries of first class officers; (4) the investment of annuity savings account contributions in annuities provided by additional licensed insurers; (5) financial difficulties faced by school corporations in funding their local early retirement and severance plans; (6) the increase in the unfunded liability of the new TRF plan; (7) the fiscal impact of a minimum benefit for PERF and TRF; (8) the fiscal impact of proposals concerning health insurance for retired state employees; (9) the fiscal impact of proposals concerning prescription drug coverage for retired state employees; (10) the fiscal impact of proposals concerning earnings limitations for reemployed PERF and TRF members; (11) a proposal to increase the maximum amount that may be deposited into a cafeteria plan on behalf of a retiring state employees who have unused leave days; and (12) a request from the Commission on Military and Veterans Affairs requesting the Pension Management Oversight Commission to consider legislation that would allow PERF and TRF members to purchase military service credit. The Commission also reviewed preliminary drafts of proposed legislation concerning the Judges' Retirement Fund, the Prosecuting Attorney Retirement Fund, and miscellaneous PERF and TRF administrative issues.

At its fourth and final meeting of the interim, held on October 24, 2000, the Commission discussed and adopted proposed recommendations concerning: (1) the Judges' Retirement Fund; (2) the Prosecuting Attorneys Retirement Fund; (3) miscellaneous PERF and TRF administrative issues; (4) the PERF and TRF retiree earnings limitation; (5) Pension Relief Fund issues; (6) the cafeteria plan for retired state employees; (7) military service credit for PERF and TRF members; and (8) state distributions for local school retirement plan liabilities.

The Commission also heard testimony from the executive directors of TRF and PERF summarizing the contents of the funds' annual reports. The actuary for TRF testified concerning liabilities under the "new" TRF plan that are due to teachers who were members of the closed TRF plan but then become employed by a different school corporation and therefore become members of the "new plan." The Commission also voted to recommend further study on the issues of: (1) a minimum benefit for PERF and TRF members; (2) using a 401(a) plan for pre-retirement conversion of state employees' unused leave days; and (3) health insurance and prescription drug coverage for retired state employees. The Commission discussed the issue of Marion County constable membership in PERF, but it did not adopt a recommendation on that issue. The Commission heard testimony concerning the response of PERF and TRF to legislation concerning post-retirement benefit option changes. The Commission also adopted its final report for the interim.

IV. SUMMARY OF TESTIMONY

PERF and TRF Funding Issues

The Commission heard testimony on this topic from the actuaries for PERF and TRF. The actuary for PERF provided a listing of the unfunded actuarial accrued liabilities and the "funded ratios" of the defined benefit plans administered by PERF. He testified that PERF's funded ratio (which is computed by dividing the plan's assets by the plan's actuarial accrued liability) is 109%.

The PERF actuary stated that the funding ratio of the pre-1977 police and firefighter funds was only 14.9%, even when the assets in the state Pension Relief Fund are considered to be assets of those funds. He explained that assistance from the Pension Relief Fund is the only state-funding mechanism to help cities and towns pay their pension liabilities from pre-1977 funds, and he noted that the Pension Relief Fund pays for roughly one-half of the benefits paid from those funds.

The Commission also heard testimony explaining that because of the relatively short life-span of the Pension Relief Fund, its assets were not invested in equities to the same extent as the pension funds administered by PERF.

The actuary for TRF distributed a summary of the membership and actuarial condition of TRF. She testified that the General Assembly had taken steps over the last six years that have improved TRF funding, including the creation of the pre-funded "new" TRF plan in 1995 and the creation of the Pension Stabilization Fund. According to the TRF actuary, the pre-1996 "closed" TRF plan had, as of June 30, 1999, over 56,000 active members and more than 32,000 retired members. She stated that the annual state-financed portion of the benefits for these members is $330 million, and that over the next 30 years this payout will grow to $1.5 billion. She testified that, as of June 30, 1999, the unfunded accrued liability of TRF's closed plan was more than $7.4 billion, which is a 39.6% funding ratio (improved from 36% in 1998). She also noted that it is estimated that over the next 15 years the closed plan's unfunded accrued liability will increase to $11 billion, assuming no cost of living adjustments, or to $16 billion, assuming a 2% cost of living adjustment each year.

The TRF actuary informed the Commission that TRF's new plan, which consists of persons hired after 1995, had over 21,000 active members and an unfunded accrued liability of $258 million on June 30, 1999. She stated that the new plan's current contribution rate of 8.5% of member payroll would have to be increased to amortize this unfunded accrued liability.

Pension Relief Fund Issues

At its first two meetings the Commission heard testimony related to pension relief for municipal police and firefighter pensions. The PERF actuary testified concerning projected distributions from the Pension Relief Fund. This witness noted that the Pension Relief Fund was established in 1977 to assist municipalities with the burden of funding police and firefighter pensions, and he explained that the Pension Relief Fund provides two distributions: (1) the "K formula" distribution, which is designed so that a municipality's share of benefits would only increase at a certain percentage each year until the Pension Relief Fund assets ran out; and (2) the "M formula" distribution, which provides pension relief distributions so that a municipality's share of pension benefits would remain at a level percentage of maximum property tax levies.

The witness briefly described the following additional steps that the General Assembly has taken to help municipalities meet their police and firefighter pensions: (1) an appropriation of $100 million during the 1990s; (2) moving the "converted members" of the pre-1977 plans away from the responsibility of the municipalities and into the 1977 Fund; and (3) providing in 1999 for a $20 million annual contribution (from lottery revenue) to the "M" portion of the Pension Relief Fund.

The Commission also heard testimony on possible options for changes to the pension relief system. This testimony noted that the Pension Relief Fund distributions for each year are based on prior-year data, and that during its 2000 Session the General Assembly had considered legislation that would have changed the distributions so that they would be based on current-year data. Other options concerning short-term pension relief were discussed, including: (1) moving additional "converted members" to the 1977 Fund; (2) moving beneficiaries of members who died before May 1, 1977, to the 1977 Fund or to the Death Benefit Fund; or (3) providing additional relief under a formula that would consider the relative pension funding needs of municipalities. In addition, the Commission also heard testimony concerning the possibility of providing additional funding to hold the aggregate municipal share of pension obligations to a 5% growth trend.

The actuary for PERF provided the Commission with current projections of distributions that will be paid from the Pension Relief Fund. This witness stated that under the current distribution statutes there will be a funding shortfall of approximately $36 million (2001 present value) beginning around 2021 if the Fund were to hold the municipal share to a 5% growth trend. The witness also provided the Commission with a chart showing the ratio of cities' accrued liability under the old police and firefighter plans to the cities' maximum property tax levies, and he noted that the ratio for the state as a whole is almost 350%.

The Commission also heard testimony stating that: (1) 48.1% of the old police and firefighter pension benefits (including benefits of so-called "convertees") were paid from pension relief distributions in 1999; and (2) providing funding necessary to enable Pension Relief Fund distributions to cover 50% of benefit distributions for the life of the old plans for old plan members would require an additional $104 million (2001 present value) from the Pension Relief Fund plus an additional $305 million (2001 present value) beginning in 2018.

The Commission heard testimony from a representative of the Indiana Association of Cities and Towns (IACT), who stated that the funding of pension liabilities under the old police and firefighter pension funds is one of the most important issues facing Indiana's municipalities. The witness noted that at IACT's annual conference, a workshop on this issue had formed a number of recommendations concerning the funding of pensions, and that after these were distributed throughout the state IACT has heard only positive comments on those recommendations.

He explained that the amount of pension relief provided by the state varies substantially between municipalities, and that IACT was proposing that the State would contribute at least 50% of old fund pension payments for a ten year period, beginning July 1, 1998. The witness also stated that under the current law, pension relief fund distributions are made to municipalities by PERF each July and October as a reimbursement for the previous year's pension payments, and that IACT is also proposing that the State should advance the payments one year so that distributions would be based on current-year projections. Under the proposal, municipalities would be required to use the advance payment only for increases in future pension payments. The proposal also would allow municipalities to set up an account within the Pension Relief Fund to save for future pension payments.

The mayors of a number of Indiana cities testified in favor of the proposals. These witnesses testified concerning the size of the unfunded liabilities for old police and fire pensions relative to municipal maximum property tax levies. A number of them commented that because of controls on property tax levies, municipalities will face the possibility of cutting existing services in order to fund pension benefits. One of the witnesses stated that the 50% funding proposal would allow taxpayers across the state to share an equal percentage of the old funds' unfunded liability, and that receiving the Pension Relief Fund distributions on a current-year basis would allow for better budgeting by municipalities.

Representatives of the professional firefighters union and the Fraternal Order of Police also testified in favor of the proposals.

PERF and TRF Investment in Equities

The Commission heard testimony from Mr. William Sheldrake, President of the Indiana Fiscal Policy Institute (IFPI), concerning the impact of equity investments on Indiana's public pension funds. He began by noting that the IFPI has published a report examining the performance of Indiana's public pension funds since the 1996 amendment to the Indiana Constitution authorizing investment in equities.

According to the report, from May 1997 through December 31, 1999, the annualized return of PERF's equity investment was 24.2%, only slightly behind the 25.5% annualized return of the S&P 500 during that same period. The annualized return on the equity investments of TRF from August 1998 (when it began investing in equities) through December 31, 1999, was 28.9%, ahead of the S&P 500's annualized return of 21.3% during that period.

Mr. Sheldrake testified that Indiana has benefitted from the 1996 Constitutional change and the investment of PERF and TRF assets in equities. According to the IFPI's report, if the pension funds' assets had still been invested entirely in bonds over the past three years, their earnings would have been approximately $1.874 billion dollars less.

The Commission also heard testimony from Mr. Sheldrake concerning whether other asset classes could increase the pension funds' returns and reduce their risk. In its study of other public pension funds, the IFPI found that private equity is the most popular type of asset class that is not invested in by PERF or TRF. According to the report, 37 states have allocated a portion of their pension fund assets to private equity investments, and on December 31, 1998, the average state pension fund had approximately 2.2% of its assets invested in private equity. The witness testified that because private equity has a low correlation with public equity, adding it to a portfolio may lower the overall risk, even though private equity as a class may by itself be riskier than public equity.

The IFPI's findings show that over the period 1969 - 1998, the annualized return of private equity investments was 17.2%, higher than returns on investments in large company stocks (12.7%), small company stocks (12.1%), and long-term corporate bonds (9.1%) during the same period. Mr. Sheldrake of the IFPI testified that the report shows that it makes sense for Indiana's pension funds to invest in private equity, as this should increase their return while lowering overall risk. This witness also stated that if the public pension funds were to move into private equity investments, they should do so slowly and should adhere to the following best practices: (1) commit to private equity for the long term; (2) use external expertise; (3) develop internal expertise; and (4) put fiduciary duty first in developing the private equity program. The IFPI report also described indirect economic benefits that may result from the investment in private equity.

PERF and TRF Earnings Limit

At all four of its meetings during the interim, the Commission heard testimony related to the PERF and TRF earnings limit and how that limit has been affected by recent changes in federal law. Witnesses explained that before recent changes in federal law, a PERF or TRF member who was receiving pension benefits and was then reemployed in a PERF-covered or TRF-covered position could continue receiving benefits until the member earned more than the Social Security normal retirement age earnings limit. If the member earned more than the federal limit, Indiana law provided that the member's benefit would stop and that the member must begin making contributions.

The Commission heard testimony explaining that in April of 2000, federal legislation was enacted that eliminates the Social Security earnings limitation beginning with the month a person attains full retirement age (currently age 65). Because this federal act eliminated the earnings limit that is referenced by Indiana law, there is therefore no earnings limit for PERF and TRF retirees who return to work in PERF-covered or TRF-covered positions.

Witnesses outlined a number of approaches the General Assembly could take concerning this issue: (1) reinstating an earnings limitation based on what the federal earnings limitation would have been if it had not been repealed ($17,000 in 2000, increasing to $30,000 in 2002); (2) paralleling the Social Security reduction for retirees younger than the Social Security normal retirement age (i.e., a retiree in 2000 who is less than age 65 would have an earnings limit of $10,800; a retiree age 65 or older would have no earnings limit); or (3) providing that there is no earnings limit for PERF and TRF retirees.

Other issues discussed by the Commission included: (1) if an earnings limit is or is not reestablished, what benefit should retirees earn during their period of reemployment; and (2) what choices should a reemployed retiree have concerning the payment option for his or her benefits.

A representative of the Indiana Association of Cities and Towns commented that municipalities would consider it an unfunded mandate if they were required to pay additional amounts as PERF employers because of an absence of an earnings limitation.

The Commission also heard testimony stating that if no earnings limit were put back in place, the costs to PERF could amount to an additional 2% of payroll. The actuary for PERF provided a fiscal impact estimate for a proposal that would: (1) allow retirees who are past the Social Security normal retirement age to: (i) continue to receive their original benefit and (ii) accrue additional benefits during their period of reemployment in a PERF-covered or TRF-covered position, based solely on service and compensation in that reemployment period; and (2) provide that PERF or TRF members who retire before normal retirement age would be subject to an earnings limitation if they were reemployed in PERF-covered and TRF-covered positions. The actuary estimated that under such a proposal PERF would experience a $49.9

million increase in its unfunded liability, with a 0.3% increase in cost as a percentage of payroll.

The actuary for TRF also provided an estimate of the fiscal impact of the proposal described above. According to the estimate, such a proposal would increase TRF's unfunded liability by approximately $61.7 million, and it would increase the contribution as a percentage of payroll by 0.12% (old TRF fund) and 0.11% (new TRF fund).

PERF and TRF Benefit Structure

At its second and third meetings, the Commission discussed proposals to change the PERF and TRF benefit structure in a way that would benefit long-term, lower-paid employees. The Commission heard testimony explaining that PERF and TRF are unique among public pension plans because the employee contributions of a member provide a benefit independent of the employer-financed pension. The counsel for PERF provided a chart comparing public pension benefits provided by the various states. The witness commented that to provide an accurate comparison between Indiana pension benefits and those in other states, it is necessary to consider Indiana's annuity savings account benefit.

The Commission also heard testimony that: (1) 23 states provide a minimum retirement benefit level, based on a number of different factors, for example the number of years of service; and (2) 1,901 PERF members receive a monthly benefit of less than $100, and 576 TRF members receive a monthly benefit of less than $100.

Witnesses testifying in favor of the minimum benefit concept gave a number of examples of retired public employees who are receiving low benefits and face high health insurance costs. One witness suggested that the benefit structure could perhaps be changed to provide a minimum benefit based on some dollar amount for each year of service, or perhaps longer-serving retired employees could receive "bonus" years of service for purposes of calculating their pensions.

The actuary for PERF provided a fiscal impact analysis for a proposal to provide a minimum monthly benefit of $300 or $400 to PERF members who retire at normal retirement age with the normal form of benefit (with other benefit options actuarially adjusted). The witness noted that approximately 2/3 of PERF members currently receive benefits of less than $400 per month.

The actuary estimated that implementing a $400 minimum monthly benefit would increase PERF's unfunded liability by $572 million and would increase the payroll percentage cost by approximately 2.0%. He estimated that implementing a $300 minimum monthly benefit would increase PERF's unfunded liability by $289 million and would increase the payroll percentage cost by approximately 1.1%.

The actuary for TRF testified that the cost increases for TRF if such minimum benefits were implemented would not be as great, because the TRF average benefit is much higher than the average PERF benefit, and therefore fewer members would be affected by the proposed minimums. She stated that the average monthly pension for members electing straight life forms of benefits at normal retirement age is $851 (old fund) and $1,124 (new fund), and she estimated that a $400 minimum would add $45.4 million to TRF's unfunded liability and increase the payout in the first year by $5.5 million. She estimated that a $300 minimum would add $23.5 million to TRF's unfunded liability and increase the payout in the first year by $2.7 million.

Judges Retirement Fund Issues

Judge Tom Milligan, Judge of the Montgomery Circuit Court and Vice President of the Indiana Judges Association, proposed legislation on behalf of the Association to: (1) require the benefit paid to members under the 1985 judges benefit system to be increased by the same percentages as benefits are increased for PERF members; and (2) provide that magistrates are members of the 1985 judges benefit system, rather than being members of PERF. Judge Milligan explained that Commission had previously recommended the two proposals. At its third meeting, the Commission reviewed a preliminary draft of the proposed legislation. The Commission also heard testimony from other witnesses supporting the proposals.

Prosecuting Attorneys Retirement Fund Issues

Mr. John Larson, Warren County Prosecuting Attorney, testified in support of a proposal that would: (1) provide for vesting in the Prosecuting Attorneys Retirement Fund (PARF) for prosecutors at eight years, rather than ten; (2) increase the percentage multipliers used in determining prosecutor pensions; (3) reduce the early retirement "reduction factor"; (4) establish a cost-of-living adjustment (COLA) tied to PERF COLAs; and (5) repeal the requirement that members continue to contribute to PARF after 22 years of service. At its third meeting, the Commission reviewed a preliminary draft of the proposed legislation. The Commission heard additional testimony in favor of the proposal. Witnesses noted that the Commission had previously recommended similar proposals.

Miscellaneous PERF and TRF Administrative Issues

The Commission heard testimony from PERF recommending that an expedited or simpler process be established for units in PERF that wish to add new positions to PERF coverage. The proposed expedited coverage process would not be available to units entering PERF as a whole, but only to units currently in PERF that are covering additional positions. The Commission also heard testimony from TRF proposing that all of its employees should be members of TRF.

The Commission also heard testimony concerning a proposed change that would clarify, effective January 1, 2001, that the additional annuity savings account contributions that may be made by a PERF member or a TRF member may not exceed 10% of the member's compensation, and that it is the intent of those funds to administer this provision in accordance with this proposed change as of January 1, 2001, if the Commission recommends this change.

A representative of the IACT testified that while municipalities may make partial payments toward police or firefighter employee contributions, the statutes do not allow municipalities to make partial payments of civilian employees' PERF employee contributions.

The Commission also heard testimony that there are inconsistent firefighter reemployment policies in Indiana law, because the 1925, 1953, and 1977 funds allow a firefighter to be reappointed if the member can complete 20 years of service before reaching age 60, while the 1937 fund law does not include this provision.

At its second and third meetings, the Commission reviewed a preliminary draft of proposed legislation addressing various administrative issues.

Health Insurance for Retired State Employees

The Commission heard testimony asserting that 19 states provide fully-paid health insurance for their retired employees, and Indiana and Nebraska are the only two states that do not allow persons over age 65 to participate in state health insurance plans. Witnesses testified that some state employees eligible for retirement cannot retire because they are unable to afford health insurance after paying for other living expenses. A witness told the Commission that she is assisting in the gathering of a petition requesting affordable health insurance to be made available to retired state employees.

A representative of the Indiana State Employee Association commented that the state achieves a certain amount of savings when an experienced employee retires and is replaced by a less experienced employee who is generally paid less than the retiring employee. The witness stated that this savings could be used to pay for retiree health insurance.

The Commission also reviewed a preliminary draft of proposed legislation concerning retiree health insurance. The legislation reviewed by the Commission would require the state to pay the employer's share of the health insurance premium for retired state employees who are not eligible for Medicare coverage and who meet certain other requirements.

Staff provided the Commission with an estimate of the fiscal impact of such a proposal, predicting that the net cost to the state would be between $1 million and $7 million annually. Staff explained that under existing law, retired state employees must pay the entire cost of their health insurance in order to participate in the health insurance program. The fiscal impact estimate noted that: (1) the costs to the state for paying the employer's share for retirees who are currently participating (and who are currently paying the entire premium) would be approximately $1.1 million annually; (2) there are approximately 1,200 retirees who are not currently participating in the health insurance program but who would have an increased incentive to participate if the state were to pay the employer's share of the premium; (3) depending on the number of these persons who actually begin participating and depending on their claims experience, their net cost to the state could be between $4 million and $10 million annually; and (4) if some active employees chose to take early retirement because they would find health insurance more affordable, and they are replaced by lower-salary employees, the state could experience cost-savings from lower salary and fringe benefits.

Prescription Drug Coverage for Retirees

Ms. Kathleen Gifford, Chair of the Indiana Prescription Drug Advisory Committee, briefly described to the Commission the recommendations made by the Advisory Committee. She first noted that senior citizens in Indiana spend approximately $1 billion per year on prescription drugs, and she commented that the problem required a national solution and action by the United States Congress. She then explained that the Advisory Committee had recommended that the State should implement a two-phase senior citizen prescription drug program: (1) Phase I would be a refund program for costs incurred in purchasing the drugs; and (2) Phase 2 would be a point-of-sale program. The recommendations also provided that the program should be targeted at low-income seniors (at or below 135% of the federal poverty level).

The Commission also reviewed preliminary drafts of proposed legislation that would require the state to offer coverage for prescription drugs to retired state employees who are not wholly covered for prescription drugs under another plan of assistance or insurance. Staff provided an estimate of the fiscal impact of a proposal to provide prescription drug coverage for retired state employees if the retired employees pay the same amounts paid by active employees for such coverage. Staff estimated the state's share of the cost of such a program to be between $13.8 million and $14.4 million.

Police and Firefighter Pensions Based on Actual Salary

The Commission heard testimony from Representative Scott Pelath and other witnesses suggesting that police and firefighter pensions under the 1977 Fund should be based on actual salaries, rather than on salaries of first class officers.

The actuary for PERF provided the Commission with information on the cost of basing police and firefighter pensions under the 1977 Fund on actual salaries, noting that it is difficult to give such an estimate because PERF does not receive individual salary information on members of the 1977 Fund. The witness stated that after sampling a number of cities, he estimated that moving to a pension based on a five-year average of high salary would increase the 1977 Fund's actuarial accrued liability by about $39 million. He estimated that such a change would require an increase of approximately $8.9 million in annual funding by municipalities (from $74 million to $82.9 million). The witness explained that the contribution rates for employers and employees would not change (21% and 6%, respectively), but that these contributions would be based on actual salaries, which in most cases would be a higher amount than the first class officer salary.

School Corporation Retirement Plan Conversion

The Commission heard testimony from Senator Robert Jackman concerning financial problems for school corporations with regard to local severance and retirement plans. The business manager of Shelbyville Central Schools testified concerning the school district's early retirement and severance payment liability. This witness described steps that the school district has taken to limit its liability, including the establishing of a 401(a) defined contribution plan.

A representative of the Indiana Association of Public School Superintendents explained that the approach taken during the past session to assist South Bend schools with their early retirement and severance liability would only work with school corporations that have enough excess capacity in their capital projects fund and transportation fund so that any bonds issued could be paid without an increase in taxes. This witness testified that courts have held that a number of early retirement plans violate the federal Age Discrimination in Employment Act (ADEA). He urged the Commission to consider the possibility of using state funds to assist schools that have found themselves with plans that run afoul of the ADEA or IRS tax rules.

Senator Jackman testified that he hoped the problems could be addressed on a state-wide basis, rather than having the General Assembly pass separate legislation for each school corporation.

Other School-Related Issues

A representative of the Indiana Association of Public School Superintendents also briefly testified on two other pension-related issues facing school corporations: (1) the unfunded liability of the new TRF fund is increasing, because the liabilities of teachers in the old TRF fund who are rehired are transferred to the new fund, but no assets are transferred to pay for those liabilities; and (2) the Department of Education should be allowed to employ retired teachers without the teachers' pensions being affected. He stated that it may be the case that growing school districts are experiencing the most difficulty from transfer of liabilities from the old TRF fund. The actuary for TRF commented that when liability for a reemployed teacher is transferred to the new TRF fund, there are no assets other than employee contributions available to transfer along with the liability.

The actuary for TRF also testified that liabilities for teachers who are re-hired after June 30, 1995, are funded through the new TRF plan. She stated that approximately 80% of the accrued liability in the new plan is attributable to members transferred from the closed plan. She stated that the TRF actuaries have recommended to the TRF Board that the current 8.50% employer contribution rate for the new TRF plan should be increased to 9.0%.

Cafeteria Plan for Retired State Employees

Staff provided the Commission with a brief description of a proposal concerning the cafeteria plan for retired state employees. Under this proposal, the maximum amount that may be deposited into a cafeteria plan on behalf of a participating retired state employee who has unused vacation, sick, or personal days would be increased from $5,000 to $10,000

401(a) Plan for Converting Unused Accrued Leave of State Employees

Mr. Dan Novreske of the State Budget Agency testified before the Commission concerning the possibility of using a 401(a) plan for converting unused accrued leave of state employees. He began by explaining that state employees have $177 million of accumulated leave time, and that many employees will not use all of their accumulated time. He noted that the upon an employee's separation from service, the state will pay for up to 225 hours (30 days) of unused vacation time. This witness then described the Section 125 cafeteria plan that was established in 1999 for state employees retiring after July 1, 1999, and he explained that the funding of these accounts, which may be up to a maximum of $5,000 per person, is done on a post-retirement basis. He said that the State Budget Agency is considering the possibility of allowing state employees to convert unused leave time into amounts that will be deposited in a 401(a) qualified plan. He stated that this approach would allow employees who do not use all of their leave time to convert those days on a pre-retirement, tax-deferred basis, and he explained that an employee would be able to self-direct the investment of the employee's account balance.

The witness said that it will take additional study to determine whether such a 401(a) plan would replace the current cafeteria plan for unused leave time, or whether the 401(a) plan would exist in addition to the cafeteria plan. He stated that state employees would each year be given the opportunity to "sell back" to the state their unused leave time that is in excess of thirty days, and he said that the amount the state would pay for the days might be equal to 50% of the employee's pay for that day.

A representative of the Indiana State Employees Association stated that under such a plan the amount paid by the state for unused days should not be discounted. A representative of the American Federation of State, County and Municipal Employees (AFSCME) stated that she would review the proposal.

Indiana Deferred Compensation Plan

The Commission heard testimony from the President of Indiana Deferred Compensation Plan, Inc. The witness began by noting that IDCP has been the service manager of the Indiana Public Employee Deferred Compensation Plan since the plan's inception in 1981, and that as of June 30, 2000, there were 29,000 state and local government employees participating in the plan, and that these employees had accumulated assets of $471 million.

The witness stated that in 1999 the General Assembly approved the establishment of a 401(a) defined contribution plan that would allow employers to match a portion of employees' contributions, and that during the first eight months since the inception of the matching benefit, 8,000 additional state employees have enrolled in the deferred compensation plan. He noted that 60% of state employees currently participate in the plan, and that the state contributes approximately $8 million annually into the employee match accounts.

The witness commented that the deferred compensation plan and other supplemental retirement programs are operated independently of PERF and TRF, and he suggested that the Commission might want to consider integrating Indiana's retirement benefit structure in order to make it more responsive to members. He also briefly described pending federal legislation that includes various proposed changes related to retirement plans.

Investment of Annuity Savings Account Contributions in Annuities Provided by Additional Licensed Insurers

A representative of American General VALIC suggested that the Commission should consider the use of a defined contribution plan to address the issue of what form of benefit should be made available to a retired PERF or TRF member who becomes reemployed in a covered position. The witness testified that studies show that most individuals change jobs at least eight times during their careers. He also stated that defined contribution plans have the advantage of budget predictability, because of the nature of their "up-front" funding, and that these plans could be used to reduce liability under a defined benefit system. The witness described the immediate vesting and portability features of defined contribution plans, and he stated that 46 states, including Indiana, have some form of defined contribution plan.

This witness suggested that the Commission should consider: (1) using defined contribution plans as an alternate to defined benefit plans; (2) using defined contribution plans as a pension supplement for extended service or continued service; and (3) using private vendors for such plans.

Commission on Military and Veterans Affairs Request Concerning Military Service Credit

Staff informed the Commission that the Commission on Military and Veterans Affairs had requested it to consider a preliminary draft of legislation that would allow PERF and TRF members to purchase service credit at actuarial cost for military service not eligible for credit under existing PERF or TRF provisions.

The Commission discussed proposed legislation providing that active members of PERF or TRF who served on active duty in the armed services for at least six months would be entitled to purchase service credit, at actuarial cost, for the time served on active duty, to the extent the service credit is not granted for that time under existing PERF or TRF provisions. Under this proposal, a member would be required to have at least ten years of creditable service in PERF or TRF before the member could use the military service credit.

Summary of PERF and TRF Annual Reports

Dr. William Christopher, Executive Director of TRF, presented the Commission with TRF's Operation's Report for fiscal year 2000. Dr. Christopher described TRF's mission statement and the goals and objectives that the Fund hopes to achieve. He noted that the report also includes a description of the "core values" that TRF desires to follow in its various working relationships.

Dr. Christopher highlighted a number of items included in the report, including: (1) a description of TRF's staffing; (2) the statement of Fund assets (which have grown from $4.9 billion as of June 30, 1999, to $5.57 billion as of June 30, 2000); (3) the statements of administrative expenses and investment expenses paid during the fiscal year; and (4) a description of the combined TRF \ PERF retirement information system project.

Dr. Christopher noted that according to the report, TRF's funding ratio, as of June 30, 1999, was 39.23%. He briefly described the schedule of benefit payouts, and he commented that the augmentation language included in the 1999 budget bill was very important. He then discussed the performance of the Fund's investments, noting that the Fund has consistently outperformed its targeted level of return. Dr. Christopher closed his presentation by describing TRF's accomplishments during fiscal year 2000 and the first few months of fiscal year 2001, and he listed for Commission members what TRF hopes to accomplish in the future.

Mr. William Butler, Executive Director of PERF, presented the Commission with a draft version of PERF's annual report. Mr. Butler noted that the Fund has more than $12 billion in assets, and that it has approximately 150,000 active members and is providing benefits to 50,000 retirees. He stated that PERF is among the 100 largest pension funds in the United States.

Mr. Butler pointed out that the annual report describes a number of major initiatives being undertaken by PERF, including the joint project with TRF to implement a new retirement information system. He also noted that the PERF Board of Trustees has commissioned studies reviewing PERF's essential functions.

After describing the provisions in the report concerning Fund assets, Mr. Butler briefly explained the section of the report summarizing the Fund's investments. He stated that since the adoption of the constitutional amendment allowing Indiana's pension funds to invest in equities, PERF has moved approximately $7 billion from fixed-income investments to equity investments. He stated that the Fund currently has 65% of its assets invested in equities, and it has 35% of its assets invested in fixed-income investments.

Marion County Constables' Election to Join PERF

The Commission discussed proposed legislation that would allow a constable elected in a township located in Marion County to elect to become a member of PERF without any action by the township board. The proposal would allow such a constable to purchase (at actuarial cost) credit for service as a constable in the township that occurred before the constable became a member of PERF.

PERF and TRF Post-Retirement Benefit Option Changes

The Commission heard testimony describing the actions taken by the PERF Board and the TRF Board in response to legislation concerning post-retirement benefit options. The witness explained that the General Assembly enacted legislation that in some circumstances allows a PERF or TRF member to change the member's designated beneficiary or form of benefit after the member has begun receiving benefits. These changes are allowed if: (1) a designated beneficiary dies while the member is receiving benefits; or (2) the member is receiving benefits and the member marries, either for the first time or following the death of the member's spouse. The witness testified that PERF and TRF are adopting new actuarial factors to reflect this legislation.

Commission Meetings

The Commission discussed the issue of whether it would be useful for it to meet throughout the year. The Chairman noted the lengthy meeting agendas, and stated the Commission's oversight duties could be better performed if they were spread more evenly throughout the year. One Commission member raised the question of whether it would be difficult for the Commission to find a quorum if it were to meet during the legislative session.

V. COMMITTEE FINDINGS AND RECOMMENDATIONS

The Commission recommended that the following bills be introduced in the 2001 Session of the General Assembly:

(1) PD 3428, concerning the Judges' Retirement Fund (7-0 vote).

(2) PD 3429, concerning the Prosecuting Attorneys Retirement Fund (7-2 vote).

(3) PD 3482, concerning miscellaneous PERF and TRF administrative issues (7-0

vote).

(4) PD 3558, concerning the earnings limitation for PERF and TRF retirees (8-0 vote).

(5) PD 3554, concerning Pension Relief Fund distributions (8-0 vote).

(6) PD 3323, concerning the cafeteria plan for retired state employees (8-0 vote).

(7) PD 3546, concerning military service credit for PERF and TRF members (8-0 vote).

(8) PD 3557, concerning local school retirement plan liabilities (8-0 vote).

(9) PD 3432, concerning Pension Management Oversight Commission meetings (7-1 vote).

The Commission also made the following policy recommendations:

(1) The Commission supports the concept of a minimum benefit for PERF and TRF members. However, additional study of the issue is needed. (8-0 vote.)

(2) The Commission should continue to study the possibility of using a 401(a) plan for conversion of state employees' unused leave time. (8-0 vote.)

(3) The Commission to should continue to study issues related to health insurance coverage and prescription drug coverage for retired state employees, including a study of whether the use of the existing cafeteria plan for retired state employees could be expanded. (8-0 vote.)

W I T N E S S L I S T

August 8, 2000
Doug Todd, McCready and Keane
Mark Webb, PERF
Mary Beth Braitman, Ice Miller
Sandy Rodwan, Gabriel, Roeder, Smith, and Co.
Dr. William Christopher, TRF Director
Tom Miller, Professional Firefighters Union of Indiana
Matt Brase, Indiana Association of Cities and Towns
Steve Moberly, Indiana Retired Teachers Association
Major Larry Larkin, Indiana State Police

September 14, 2000
Bill Sheldrake, Indiana Fiscal Policy Institute
Doug Todd
Mary Beth Braitman
Representative Scott Pelath
Mr. Jacobucci
Kathleen Gifford, FSSA
Bob Brown, AFSCME
Lynn Hajak
David Larsen, Indiana State Employee Association
Judge Tom Milligan, Montgomery Circuit Court, Indiana Judges Association
Deborah Daniels, Krieg, Devault
John Larson, Warren County Prosecuting Attorney
Phil Conklin, Retired Indiana Public Employees Association
Jodie Woods, Indiana Association of Cities and Towns

October 4, 2000
Dan Novreske, State Budget Agency
Eugene Thompson, Indiana Deferred Compensation Plan
Doug Todd
Don VanPutten, American General VALIC
Senator Robert Jackman
Mr. Michael Shreve, Shelbyville Central Schools
Roger Thornton, Indiana Association of Public School Superintendents
Denise Jones, Gabriel, Roeder, Smith, and Co.
Tom Fruechtenicht
Judge Vadic, Indiana Judges Association
Deborah Daniels
John Larson, Warren County Prosecuting Attorney

Bob Brown
Dave Larsen
Cordelia Lewis

October 24, 2000
Dr. William Christopher, TRF Executive Director
William Butler, PERF Executive Director
Denise Jones
Mary Beth Braitman
Matt Brase
Mayor David Heath, City of Lafayette
Mayor Ted Ellis, City of Bluffton
Mayor Ernie Wiggins, City of Warsaw
Mayor Graham Richard, City of Ft. Wayne
Kathy Davis, Controller, City of Indianapolis
Tom Miller
Leo Blackwell, Fraternal Order of Police
Doug Todd
Dave Larsen
Bob Brown
Dan Novreske
Senator Robert Jackman